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Supreme Court, U.S.
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No. 99-1016

IN THE

Supreme Court of the United States

JOHN S. PEREIRA, Esq., as Chapter 11 Trustee of the Estate of Payroll Express Corporation, *et al.*,

Petitioner,

v.

AETNA CASUALTY & SURETY COMPANY, FEDERAL INSURANCE COMPANY, CHUBB GROUP OF INSURANCE COMPANIES, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION FOR RESPONDENTS LONDON EXCESS UNDERWRITERS

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QUESTIONS PRESENTED

1. Whether this Court should grant a petition for certiorari in a simple breach of contract case that: (a) is governed by the laws of the State of New Jersey; and (b) does not involve any issues of federal or constitutional law? *The Respondents, London Excess Underwriters ("LEU"), submit that the question should be answered in the negative.*[1]

2. Whether the United States Court of Appeals for the Second Circuit correctly applied New Jersey law when it affirmed the District Court's rescission of the LEU Policies on the grounds that Payroll Express Corporation ("PEC") had misrepresented material facts in applying for the LEU policies? *The LEU submit that the question should be answered in the positive.*

3. Whether the United States Court of Appeals for the Second Circuit correctly applied New Jersey law when it held that in actions for contract rescission, an agent's misrepresentations bind the principal if the agent was authorized to represent the principal in obtaining the contract? *The LEU submit that the question should be answered in the positive.*

4. Whether the United States Court of Appeals for the Second Circuit correctly applied New Jersey law when it held that the only party which had a right to claim under the LEU Policies was the insured, PEC (or PEC's Trustee), and that PEC's creditors had no such right to make a claim? *The LEU submit that the question should be answered in the positive.*

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1. The LEU include all those parties named in the petition as Respondents except Aetna Casualty & Surety Company, Federal Insurance Company, and the Chubb Group of Insurance Companies.

PARTIES TO THE PROCEEDING

The only parties to this proceeding are: PEC's Trustee, who is making a claim on behalf of the bankrupt insured, PEC; and the Respondent Insurers. None of PEC's creditors is a party to this proceeding.

STATEMENT PURSUANT TO RULE 29.6

The following companies are included among the London Excess Underwriters:

1. SPHERE DRAKE INSURANCE PLC.;
   Odyssey Re; London, Fairfax Financial Holdings

2. INSURANCE COMPANY OF NORTH AMERICA (UK) LIMITED "G" ACCOUNT;
   Cigna Corporation

3. INSURANCE COMPANY OF NORTH AMERICA (UK) LIMITED CE MAR A/C;
   Cigna Corporation

4. ZURICH RE (UK) LIMITED;
   Zurich Insurance Company

5. NIPPON INSURANCE COMPANY OF EUROPE LIMITED;
   Nippon Fire & Marine Ins. Co. Ltd.

6. EXCESS INSURANCE CO., LTD.;
   The Hartford Financial Services Group, Inc. (Delaware)

7. OCEAN MARINE INSURANCE CO., LTD.;
   Commercial Union Assurance Co., Plc., Commercial Union Plc.

8. ASSICURAZIONI GENERALI S.P.A.;

9. THE THREADNEEDLE INSURANCE CO., LTD.;
   Eagle Star Re; British American Tobacco

10. PHOENIX ASSURANCE PLC. LSA ACCOUNT;
    Royal & Sun Alliance Insurance Group Plc.

11. COLONIA INSURANCE (UK) LIMITED "TR" ACCOUNT;
    Axa-UAP, Axa Colonia, Tryg Baltica Forslkring

12. THE PRUDENTIAL ASSURANCE COMPANY LIMITED TRUST ACCOUNT NO. 2;
    Prudential Corporation, Plc., Pearl Assurance Company, Plc.

13. CORNHILL INSURANCE PLC. LONDON UK "D" ACCOUNT;
    Allianz Cornhill

14. SIRIUS (UK) INSURANCE PLC.;
    ABB AB, Stockholm (Sweden), ABB AG Baden (Switzerland)

15. NORWICH UNION FIRE INSURANCE SOCIETY, LTD., NO. 1 "M" ACCOUNT;
    C.N.A. Group of Chicago

16. COMMERCIAL UNION ASSURANCE CO. PLC.;
    Commercial Union, Plc.; CGU Plc.

17. PHOENIX ASSURANCE PLC.;
    Royal Sun Alliance Insurance Group Plc.

18. WURTTEMBERGISCHE FEUERVERSICHERUNG AG "AW" ACCOUNT;
    Wurttembergische Aktiengesellschaft Versicherungs-Beteiligungsgesellschaft, Wurttembergische und Badische Versicherungs-AG

19. NORTHERN ASSURANCE COMPANY LIMITED NO. 6 ACCOUNT;
    Commercial Union Assurance Co. Plc., Commercial Union Plc.

20. YORKSHIRE INSURANCE COMPANY LIMITED;
    General Accident Plc., CGU, Plc.

21. LONDON AND HULL MARITIME INSURANCE COMPANY LIMITED AXA T ACCOUNT.
    AXA Global Risks (UK) Limited

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The Respondents, LEU, respectfully submit this brief in opposition to the petition for a writ of certiorari requested by the Petitioner, John S. Pereira, Esq., the Chapter 11 Trustee of the bankruptcy estates of PEC, for review of the July 29, 1999 judgment of the United States Court of Appeals for the Second Circuit.

STATEMENT OF THE CASE

This insurance coverage action originated in a non-core adversary proceeding commenced by PEC's Chapter 11 Trustee against PEC's insurers for theft losses caused by PEC's co-owners and sole directors, Robert and Barbara Felzenberg (JA 55-57, 81-82, 521).[2]

Both the District Court and the Second Circuit properly concluded that no triable issue exists concerning whether PEC had misrepresented material facts in response to Questions 10 and 36 of PEC's January 1992 written LEU insurance application form. Question 10 asked PEC about its prior loss history for the preceding five years (JA 70, 956, 1211-12). In response, PEC listed just one prior burglary loss totaling $1,500,000 (JA 956, 1212). PEC failed to list on the application, however, seventeen (17) other prior fidelity and robbery losses totaling $3,018,958 (JA 70-71, 1138-85, 1212-13). In his unrebutted sworn statement, the Leading LEU Underwriter Angus Roberts stated that the large number of undisclosed prior losses indicated the inadequacy of PEC's staffing, security systems, management and internal controls (JA 1000-01, 1213). The unrebutted evidence further established that "had PEC disclosed this

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2. Citations to JA __ refer to the parties' "Joint Appendix" of the appellate record filed in the Court of Appeals.

material information in a timely manner, the [LEU] would not have agreed to insure PEC" (JA 1001, 1213). Based on these undisputed facts, both the District Court and the Second Circuit concluded that no reasonable jury could find that PEC had not misrepresented material facts in applying for the LEU policies, and both courts thus held that the LEU Policies should be rescinded. *Payroll Express*, 216 B.R. at 355-59, *reconsideration denied*, 216 B.R. at 716-18, *aff'd*, 186 F.3d at 205.

Both the District Court and the Second Circuit also properly concluded that the LEU Policies should be rescinded because PEC had misrepresented material facts in responding to Question 36 of the LEU insurance application form, which asked PEC *"[i]s there any other information which is or may become material to the proposed insurance and which is not already disclosed to Underwriters"* (JA 80-83, 957, 1214-15) [emphasis supplied]. In response, Robert Felzenberg, on behalf of PEC as its "President" (JA 959, 1210), answered *"NONE"* (JA 957, 1214) [emphasis supplied]. At the time PEC applied for the LEU Policies in early 1992, however, Robert and Barbara Felzenberg were perpetrating an embezzlement and check kiting scheme which dated back several years (JA 55, 81-82, 91, 521, 524, 532, 985, 987, 1120-35, 1214-15). This scheme, which shortly thereafter led to PEC's collapse and the Trustee's filing of the instant claim, was not disclosed to the LEU (JA 55, 81-82). Based on these undisputed facts, both the District Court and the Second Circuit concluded that no reasonable jury could conclude that PEC had not made material misrepresentations in applying for the LEU Policies, and both courts thus neld that the LEU Policies should be rescinded. *Payroll Express*, 216 B.R. at 359-60, *aff'd*, 186 F.3d at 203-10.

REASONS FOR DENYING PEC'S TRUSTEE'S PETITION

I. THIS CASE INVOLVES NO FEDERAL OR CONSTITUTIONAL ISSUES

This is a simple breach of contract suit which is governed by the laws of the State of New Jersey. In both the District Court and the Second Circuit, PEC's Trustee argued successfully that New Jersey law governed this case. *In re Payroll Express Corp.*, 216 B.R. 344, 353-55 (S.D.N.Y. 1997), *aff'd*, 186 F.3d 196, 205 (2d Cir. 1999). This case does *not* involve any issues of federal or constitutional law within the meaning of Supreme Court Rule 10(a). Consequently, this case does not involve any issues worthy of certiorari. *See Butner v. United States*, 440 U.S. 48, 57-58 (1979) ("In this Court the parties have argued the state-law question at great length, each stressing different aspects of the record. We decline to review the state-law question. The federal judges who deal regularly with questions of state law in their respective districts and circuits are in a better position than we to determine how local courts would dispose of comparable issues."); 23 *Moore's Federal Practice*, § 510.22[2] (3d ed. 1999) (while the Supreme Court is the final arbiter of all federal issues, it is not a "national expounder" of state law).

In an attempt to create a purported "conflict between the circuits," PEC's Trustee argues in POINT I of his brief that the Second Circuit's July 29, 1999 judgment conflicts with decisions rendered in the Third, Fifth, Tenth, and Eleventh Circuits.[3] That argument should be rejected, however, because

3. *See American Mfg. Mut. Ins. Co. v. Tison Hog Market, Inc.*, 182 F.3d 1284 (11th Cir. 1999); *Adair State Bank v. American Casualty Co.*, 949 F.2d 1067 (10th Cir. 1991); *FDIC v. Aetna Casualty & Surety Co.*, 426 F.2d 729 (5th Cir. 1970); *In re Lloyd Securities*, 153 B.R. 677 (E.D. Pa. 1993).

none of those other cases interpreted New Jersey law or any relevant issue of federal law. Rather, those other cases simply involved different circuit courts' interpretations of the laws of Georgia, Texas, Oklahoma, and Pennsylvania. In contrast, this Court resolves "conflicts" among the lower federal courts on points of *federal* or *constitutional* law, not state law. *Braxton v. United States*, 500 U.S. 344, 347 (1991) ("A principal purpose for which we use our certiorari jurisdiction, and the reason we granted certiorari in the present case, is to resolve conflicts among the United States courts of appeals and state courts concerning the meaning of provisions of federal law."); 23 *Moore's Federal Practice*, § 510.2[1] (3d ed. 1999).

Furthermore, even if this Court were prepared to opine on the subject of New Jersey state law, PEC's Trustee's position would still be fatally flawed because he fails to explain "how" or "why" the District Court and the Second Circuit misapplied the statutes or case law of New Jersey. Nowhere in PEC's Trustee's brief does he cite to a single New Jersey statute or decision of the Supreme Court of New Jersey which the District Court or the Second Circuit ignored or misinterpreted. This is not surprising, because no such statute or case law exists. The District Court and the Second Circuit correctly applied New Jersey law, and their decisions should be left undisturbed.

II. BOTH THE DISTRICT COURT AND THE SECOND CIRCUIT PROPERLY HELD THAT NO GENUINE ISSUE OF TRIABLE FACT EXISTED REGARDING WHETHER THE LEU POLICIES SHOULD BE RESCINDED BASED ON THE MATERIAL MISREPRESENTATIONS MADE BY PEC IN RESPONSE TO QUESTIONS 10 AND 36 OF THE APPLICATION FORM

PEC's Trustee's petition fails to identify any legal error committed by the District Court or Second Circuit in ordering rescission of the LEU Policies based on the material misrepresentations made by PEC in response to Questions 10 and 36 of the LEU application form. As explained below, both the District Court and Second Circuit correctly applied New Jersey law in ordering rescission of the LEU Policies.

A. Governing Principles Of New Jersey Law

1. Doctrine Of Equitable Fraud

In New Jersey, "[a]n insurance contract is preeminently one of the utmost good faith." *Equitable Life Assur. Soc. v. New Horizons Inc.*, 28 N.J. 307, 312, 146 A.2d 466, 469 (1958). "Under New Jersey law, an insurer may rescind a policy for equitable fraud on the grounds of false statements in the application which materially affect the acceptance of the risk or the hazard assumed by the insurer." *Hartford Life & Acc. Inc. Co. v. Nittolo*, 955 F. Supp. 331, 333 (D.N.J. 1997). The Supreme Court of New Jersey has repeatedly held that "equitable fraud" does *not* require the insurer to prove that the applicant had an intent to defraud or deceive. *Ledley v. William Penn Life Ins. Co.*, 138 N.J. 627, 635, 651 A.2d 92, 95 (1995); *Equitable Life*, 28 N.J. at 314, 146 A.2d at

470. "Even an innocent misrepresentation can constitute equitable fraud justifying rescission." *Ledley*, 138 N.J. at 635, 651 A.2d at 95.

2. Objective vs. Subjective Questions

Equitable fraud distinguishes between objective and subjective questions in the insurance application. *Ledley*, 138 N.J. at 635-36, 651 A.2d at 96. *Objective questions* seek information within the applicant's knowledge "such as whether the applicant [for a life policy] has been examined or treated by a physician." *Id.* Since an answer to this question did not call for any personal opinion, the Supreme Court of New Jersey concluded that the question was "objective" and the doctrine of equitable fraud was to be strictly applied. *Id.*; *FDIC v. Moskowitz*, 946 F. Supp. 322, 330 (D. N.J. 1996) (strict application of "equitable fraud" applies to objective questions).

Subjective questions seek to probe the applicant's state of mind with such questions as "what is the state of the applicant's health." *Ledley*, 138 N.J. at 636, 651 A.2d at 96; *Moskowitz*, 946 F. Supp. at 329. Unlike objective questions (where proof of an intent to deceive is unnecessary), subjective questions require the insurer to show that the answer was false and the insured knew it was false. *Ledley*, 138 N.J. at 635-36, 651 A.2d at 96.

3. Materiality Of The Misrepresentation

"[I]n order to award the equitable relief of rescission on the basis of a misrepresentation in the application for insurance, New Jersey law provides that the misrepresentation must be material." *Moskowitz*, 946

F. Supp. at 331. "[A] misrepresentation is material if it 'naturally and reasonably influence[s] the judgment of the underwriter in making the contract at all, or in estimating the degree or character of the risk, or in fixing the rate of premium.' " *Ledley*, 138 N.J. at 638, 651 A.2d at 97; *Moskowitz*, 946 F. Supp. at 331. "Materiality" may be competently established through testimony of the insurance underwriter. *Ledley*, 138 N.J. at 638-39, 651 A.2d at 97; *Nittolo*, 955 F. Supp. at 333; *Moskowitz*, 946 F. Supp. at 331-32.

B. PEC's January 16, 1992 Application Form

In order to obtain the LEU Policies, on January 16, 1992 PEC submitted a written application form to the LEU through its insurance brokers, Marshall & Sterling Ltd. and John Plumer & Partners, Ltd. (JA 60, 955-59, 1210). On behalf of PEC, Robert Felzenberg filled out the application form (JA 1136-37, 1210), signed the application form as PEC's "President" (JA 60, 959, 1210), and submitted the completed application form to PEC's brokers (JA 1136-37, 1210).

According to the unrebutted sworn statement of the Leading LEU Underwriter Angus Roberts, the application form furnished specified information which enabled the LEU to determine whether to accept the risk (JA 999, 1210-11). This was made clear to PEC on the top of the first page (JA 1210) of the application, which stated that:

> The completion of this form will enable underwriters to establish the nature of the proposer's operations, the extent of cover required and the rules and the procedures which will apply during the currency of the proposed insurance.

The importance of providing full and accurate information in the application was made clear on the last page of the form, immediately above the line where Robert Felzenberg signed the application:

> I/WE HEREBY DECLARE THAT THE ABOVE STATEMENTS, PARTICULARS AND ANSWERS ARE TRUE AND THAT I/WE HAVE NOT SUPPRESSED OR MISSTATED ANY MATERIAL FACTS . . . IT IS FURTHER AGREED THAT THE CONTINUED ACCURACY OF THE STATEMENTS, PARTICULARS AND ANSWERS SHALL BE A CONDITION PRECEDENT TO THE UNDERWRITERS' LIABILITY UNDER THE PROPOSED INSURANCES (JA 60, 959, 1210).

C. The Answer To Question 10 Contains Material Misrepresentations

The District Court and the Second Circuit properly held as a matter of law that PEC misrepresented material facts in response to Question 10 of the application which asked PEC *"[h]as the proposer [i.e., PEC] suffered a loss during the past five years? If "Yes," give brief details and amount involved"* (JA 60, 956, 1211) [emphasis supplied]. In response, PEC listed one (1) loss totaling $1,500,000 (JA 61, 956):

> YES: Security system for premises and vault was breached during non-operating hours. Burglary amount was $1,500,000. Occurred on 5/19/88 at our Cherry Lane, Floral Park location.

In his unrebutted sworn statement, the Leading LEU Underwriter Angus Roberts stated that it was important for the LEU to know the details of PEC's prior loss history in determining whether to insure PEC (JA 76-77, 1000). An accurate response to Question 10 would have provided the information necessary to make this decision on an informed basis (JA 76-77, 1000).

After the LEU issued the Policies to PEC, and during the investigation of PEC's Trustee's claim, the LEU learned that, in addition to the $1,500,000 loss identified in the application, PEC had sustained seventeen (17) other theft and robbery losses totaling approximately $3,018,958 during the five years prior to the date of PEC's application (JA 1000, 1212-13). The undisclosed prior losses included:

TYPE	DATE	CLAIM
Robbery	9/18/87	$ 42,000 (JA 1138-39)
Robbery	5/13/88	$ 248,000 (JA 1140)
Robbery	6/ 3/88	$ 36,000 (JA 1141)
Robbery	6/24/88	$ 285,000 (JA 1142-44)
Fidelity	10/20/88	$ 170,000 (JA 1145-46)
Robbery	3/16/89	$ 200,000 (JA 1147-48)
Robbery	5/18/89	$ 105,000 (JA 1149)
Robbery	12/28/89	$ 280,000 (JA 1150-52)
Fidelity/Robbery	5/10/90	$ 331,872 (JA 1153-54)
Robbery	7/19/90	$ 176,064 (JA 1155-57)
Robbery	7/26/90	$ 186,064 (JA 1158-59)
Fidelity	12/21/90 - 4/ 4/91	$ 63,000 (JA 1160-66)
Robbery	2/ 1/91	$ 215,958 (JA 1167-71)
Robbery	5/17/91	$ 125,000 (JA 1172-78)
Robbery	7/12/91	$ 60,000 (JA 1179-80)
Robbery	9/ 6/91	$ 230,000 (JA 1181-83)
Robbery	1/22/92	$ 265,000 (JA 1184-85)
	Total:	**$3,018,958**

Rather than truthfully informing the LEU that it had sustained 18 losses totaling approximately $4,518,958 during the prior five years, PEC stated that it had sustained only one loss totaling $1,500,000 (JA 1000). By failing to disclose to the LEU the 17 additional losses (totaling $3,018,958), PEC materially misrepresented the true facts (JA 1001, 1118). This large number of serious theft and robbery claims over such a short time period indicated the inadequacy of PEC's staffing, security systems, and internal controls (JA 76-77, 1001). Had PEC disclosed this material information about its prior loss history, the LEU would *not* have agreed to insure PEC (JA 76-77, 1001). In view of these facts, the LEU Policies were properly rescinded as a matter of law.

PEC's misrepresentations as to its prior loss history were "material" (JA 76-77, 1001). Courts have repeatedly granted summary judgment rescinding insurance policies where the insured failed to disclose its prior loss history in the application form. *Pinette v. Assurance Co. of America*, 52 F.3d 407, 411 (2d Cir. 1995) (in upholding summary judgment rescinding a policy based on the insureds' failure to disclose their prior loss history, the court concluded that "[c]ommon sense tells us that an applicant's prior loss history is material to a reasonable insurance company's decision whether to insure that applicant or determination of the premium."); *Certain Underwriters at Lloyd's v. Montford*, 52 F.3d 219, 222 (9th Cir. 1995) (insured failed to disclose prior loss record); *Cheatham v. 100% Certain Underwriters at Lloyd's*, 783 F. Supp. 1174, 1176 (E.D. Ark. 1991), *aff'd without opinion*, 985 F.2d 569 (8th Cir. 1992) (insured failed to disclose prior fire loss); *Howell v. Colonial Penn Ins. Co.*, 842 F.2d 821, 822-23 (6th Cir. 1987) (insured failed to disclose prior fire loss); *Nationwide Mut. Fire Ins. Co. v.*

Pascarella, 993 F. Supp. 134, 136-37 (N.D.N.Y. 1998) (insured failed to disclose prior judgments against him and six prior loss claims); *North Amer. Specialty Ins. Co. v. Savage*, 977 F. Supp. 725, 728-29 (D. Md. 1997) (insured failed to disclose two prior suspensions of his driver's license); *Moskowitz*, 946 F. Supp. at 329-32 (insured bank failed to disclose prior "Supervisory Directive" from federal regulators criticizing bank's operations); *Erwin DeMarino Trucking v. Jackson*, 838 F. Supp. 160, 161 (S.D.N.Y. 1993) (insured failed to disclose his long record of poor driving); *INA Underwriters Ins. Co. v. D.H. Forde & Co.*, 630 F. Supp. 76, 77 (W.D.N.Y. 1985) (insureds failed to disclose prior lawsuits); *Jaber v. Prudential Ins. Co.*, 681 N.E.2d 478, 479-80 (Ohio 1996) (insured failed to disclose prior loss).

D. The Answer To Question 36 Contains Material Misrepresentations

The District Court and the Second Circuit properly held as a matter of law that PEC misrepresented material facts in response to Question 36 of PEC's application, which asked *"[i]s there any other information which is or may become material to the proposed insurance and which is not already disclosed to Underwriters?"* (JA 61, 957) [emphasis added]. In response, PEC answered "NONE" (JA 61, 957).

At the time PEC applied for the LEU Policies, Robert Felzenberg was involved in a scheme involving bank fraud, check kiting, conspiracy to defraud, and tax evasion (JA 80-81, 1120-35). On July 13, 1993, Robert Felzenberg, in *United States v. Robert Felzenberg*, No. 93 CR. 460 (S.D.N.Y.), pleaded guilty to a four-count Criminal Information before District Judge (now Circuit Judge) Sonia Sotomayor (JA 960-96, 1120-35). His guilty plea related to the alleged losses which are the subject of the instant action. *See United States v. Robert Felzenberg*, 1998 WL 152569 ** 1-2 (S.D.N.Y. Apr. 2, 1998).

In his July 13, 1993 plea allocution, Robert Felzenberg stated that starting in the spring of 1991, he "put into effect a worthless check scheme" (i.e., a check kite) to alleviate PEC's "large cash shortages" (JA 985, 987). This admission clearly established that PEC's check kite was in effect long before PEC submitted its January 16, 1992 application to the LEU. Robert Felzenberg further admitted that the check kite enabled him to conceal from PEC's banks and customers the fact that PEC "did not have enough money to continue its check-cashing business," and that PEC's "customers would not provide funds to [PEC]" if they had known of his "worthless check scheme" (JA 987). It follows that Robert Felzenberg also understood that the LEU would *not* have insured PEC had they known of the scheme.

Robert Felzenberg prepared PEC's January 16, 1992 application (JA 60, 1136-37), signed it as PEC's "President" (JA 60, 959, 1215), and submitted it to the LEU through PEC's brokers (JA 1136-37, 1215). In response to Question 36, however, PEC did not disclose that: (a) PEC was insolvent; (b) PEC had "large cash shortages"; or (c) PEC was perpetrating a multi-million dollar check-kiting scheme to keep its business operations afloat.

Rather than truthfully informing the LEU of its insolvency, "large cash shortages," and check kite, PEC provided *no information* in response to Question 36. By failing to disclose its insolvency, "large cash shortages," and check kite, PEC misrepresented the true facts (JA 1002). Had PEC disclosed its insolvency, "large cash shortages," and check kite, the LEU would *not* have agreed to insure PEC (JA 1002). In view of these facts, the LEU Policies were properly rescinded as a matter of law.

E. The Form Of Question 36 Is Proper

In POINT II of his brief, PEC's Trustee complains that Question 36 is a "catch-all" type of question which has been rejected by state courts in Minnesota and New Jersey. This argument is entirely lacking in merit, because the two cases which PEC's Trustee cites were both reversed on appeal.

The Trustee's citation of the Appellate Division's decision in *Longobardi v. Chubb Ins. Co. of New Jersey*, 234 N.J. Super. 2, 560 A.2d 68 (App. Div. 1989), *rev'd*, 121 N.J. 530, 582 A.2d 1257 (1990), truly strains credulity because the Supreme Court of New Jersey reversed that decision and nullified the subject insurance policy based on the insured's misrepresentation of a material fact. The case supports the LEU's argument, not PEC's Trustee's.

PEC's Trustee's reliance on the unreported lower court decision in *Independent School District No. 197 v. Accident & Casualty Ins. of Winterthur*, 525 N.W.2d 600 (Minn. App. 1995), is similarly misplaced. In that case, the Minnesota Court of Appeals reversed the lower court's entry of summary judgment against the insurers and held that a genuine issue of triable fact existed as to whether the insured manufacturer (W.R. Grace & Co.) had made rescissionable misrepresentations to its liability insurers in 1974 when it answered a similar "catch-all" question in its insurance application with a negative response. *Id.* at 606. The case thus supports the LEU's position that these types of questions are proper.

Other courts which have considered the issue have also found that material misrepresentations in answers to such questions constitute grounds for rescinding the insurance policies involved. Much like Question 36 which was asked

of PEC, in *Becker, Moore & Co., Inc. v. U.S. Fidelity & Guaranty Co.*, 74 F.2d 687 (2d Cir. 1935) (Hand, J.), the insured was asked on its fidelity bond application *"[d]o you know any circumstance tending to indicate that any one employee is not a proper person to bond?" Id.* at 687 [emphasis added]. The insured's president answered "No." *Id.* After the insured made a claim, the insurer learned that both the insured's president and its secretary had embezzled money from the insured prior to the date of the application. Holding that the insured's failure to disclose this prior misconduct constituted a misrepresentation which was "material" to the risk, the court stated "it has been settled law for more than a century and a half, that such collateral misrepresentations . . . will avoid a policy." *Id.* at 688. *Accord, National Union Fire Ins. Co. v. Sahlen*, 999 F.2d 1532, 1536 (11th Cir. 1993) (directors and officers liability policy rescinded on summary judgment because the insured had failed to disclose its precarious financial condition and false accounts receivable to the insurer); *Mt. Airy Ins. Co. v. Thomas E. Angst & Assocs. P.C.*, 954 F. Supp. 1040, 1044-45 (E.D. Pa. 1997) (law firm malpractice liability policy rescinded on summary judgment because law firm's president, who had submitted the application to the insurer, had failed to reveal in the application to the insurer that he had stolen $148,869.42 from one of the firm's clients).

III. BOTH THE DISTRICT COURT AND THE SECOND CIRCUIT CORRECTLY APPLIED NEW JERSEY LAW IN HOLDING THAT IN ACTIONS FOR CONTRACT RESCISSION, AN AGENT'S MISREPRESENTATIONS BIND THE PRINCIPAL IF THE AGENT WAS AUTHORIZED TO REPRESENT THE PRINCIPAL IN OBTAINING THE CONTRACT

Without citing a single New Jersey case or statute, PEC's Trustee argues in POINT I of his brief that Robert Felzenberg's guilty knowledge about his systematic looting of PEC should not be imputed to PEC because of: (a) the doctrine of "adverse domination"; and (b) the "adverse interest" exception to general agency principles. As explained below, however, both the District Court and the Second Circuit properly imputed Robert Felzenberg's guilty knowledge to PEC under New Jersey law and, in so doing, correctly refused to relieve PEC of the consequences of Robert Felzenberg's misrepresentations.

Relying heavily on *In re Lloyd Securities Inc.*, 153 B.R. 677 (E.D. Pa. 1993), PEC's Trustee argues that Robert Felzenberg's knowledge of his own dishonest actions should not be imputed to PEC or PEC's Trustee in determining whether PEC misrepresented material facts in responding to Question 36 of the LEU application. The *Lloyd Securities* case (which purports to apply Pennsylvania law) is contrary to New Jersey law, however, and PEC's Trustee's reliance on it is entirely misplaced.

First, in New Jersey, if a principal has authorized one of its agents to speak for the principal in the course of obtaining a particular insurance contract and that agent makes false statements to the insurer in applying for the insurance contract,

the agent's false statements are binding on his principal. *Equitable Life Assur. Soc. v. New Horizons Inc.*, 28 N.J. 307, 314, 146 A.2d 466, 470 (1958) (in rescinding a policy based on the false statements given by an employee of the employer-insured to the insurer, the Supreme Court of New Jersey stated that "[i]n an action brought for rescission, an agent's false statements bind his principal if such agent was authorized to speak for the principal in the course of obtaining the particular contract . . . [t]he fact that [the principal] was ignorant of [the agent's] deceptions is of no avail.") [citations omitted]. Here, it is undisputed that Robert Felzenberg was authorized to speak on behalf of PEC in the course of obtaining the LEU Policies because he was PEC's President (JA 60, 959, 1215). Therefore, under New Jersey law, Robert Felzenberg's false statements bind PEC. *Id.*[4]

Second, the *Lloyd Securities* court rejected the insurer's rescission defense based on the Pennsylvania law of "adverse domination." In the instant case, however, the Second Circuit correctly observed that, as yet, no New Jersey court has ever applied the doctrine of adverse domination. *Payroll Express*, 186 F.3d at 206; *In re McGregor Sporting Goods, Inc.*, 199 B.R. 502, 515 (Bankr. D.N.J. 1995) (refusing to apply doctrine of adverse domination because no New Jersey court had ever previously done so). Therefore, given that New Jersey has never adopted the doctrine, the *Lloyd Securities* case should be rejected as authority in this case.

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4. Contrary to PEC's Trustee's assertion, Robert Felzenberg's knowledge of his false statements is imputable to PEC's Trustee because PEC's Trustee is subject to the same defenses which the LEU have against PEC and possesses no better rights than those which he obtained from PEC. *Bank of Marin v. England*, 385 U.S. 99, 101 (1965); *In re Joe Sipala & Son Nursery Corp.*, 214 B.R. 281, 290-91 (Bankr. E.D.N.Y. 1997).

Third, the *Lloyd Securities* court's rejection of the insurer's recission defense was contrary to the holdings of all of the other fidelity/crime insurance cases which have applied the doctrine of adverse domination. Those cases applied the doctrine solely for the purpose of tolling the period in which the insured was required to have discovered the loss and provided notice of a claim to its insurer.[5] With the exception of the *Lloyd Securities* case, no fidelity/crime insurance case has ever applied the doctrine to vitiate a rescission defense. The Second Circuit properly refused to follow *Lloyd Securities* because that decision extended the doctrine "well beyond its equitable tolling roots." *Payroll Express*, 186 F.3d at 206.

Fourth, the *Lloyd Securities* court's novel extension of the doctrine of adverse domination was improvident because it violated the equitable doctrine of "unclean hands." It is well-settled that PEC's Trustee is subject to the same defenses which the LEU have against PEC. *Bank of Marin*, 385 U.S. at 101; *In re Joe Sipala*, 214 B.R. at 290-91. Moreover, at his July 13, 1993 plea allocution Robert Felzenberg stated that the check kite which demonstrably

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5. *See California Union Ins. Co. v. American Div. Sav. Bank*, 948 F.2d 556 (9th Cir. 1991); *J.I. Corp. v. Federal Ins. Co.*, 730 F. Supp. 1187 (D. Mass.), *aff'd*, 920 F.2d 118 (1st Cir. 1990); *Paradis v. Aetna Casualty & Surety Co.*, 796 F. Supp. 59 (D.R.I. 1992); *Kehoe v. Peerless Ins. Co.*, 1980 WL 1425 (D. Mass. 1980); *Mutual Sec. Life Ins. Co. v. Fidelity & Deposit Co. of Md.*, 659 N.E.2d 1096 (1995); *Admiralty Fund v. Peerless Ins. Co.*, 191 Cal. Rptr. 753 (1981). The doctrine is often invoked by the Receiver or Trustee for an insolvent corporation which was dominated by a malefactor who looted the company. The doctrine has been invoked to toll the period in which the insured was required to have discovered the loss under its fidelity/crime policy until after the controlling malefactor was removed from his position of power.

benefitted PEC began in the spring of 1991, approximately a year prior to the inception of the LEU Policies (JA 985, 987). In view of such "unclean hands," PEC and its Trustee cannot equitably expect this Court to apply the adverse domination theory and to reject the rescission defense of innocent parties such as the LEU. *See Keystone Drilling Co. v. General Ex. Co.*, 290 U.S. 240, 247 (1933); *Unterman v. Unterman*, 19 N.J. 507, 517-18, 117 A.2d 599, 604-05 (1955).

Finally, in addition to the *Lloyd Securities* case, PEC's Trustee has cited three other cases to support the proposition that Robert Felzenberg's false statement in response to Question 36 should not be imputed to PEC.[6] Each of these cases is distinguishable, however, because none of them applies New Jersey law or addresses the issue of whether an agent's false statements bind his principal where that agent was authorized to speak for the principal in the course of obtaining the policy.

IV. PEC'S CREDITORS HAVE NO RIGHTS UNDER THE LEU POLICIES

PEC's Trustee argues that Robert Felzenberg's false statement in response to Question 36 should not be imputed to PEC because it would only further victimize PEC's creditors. This argument should be rejected because: (a) the creditors are not named as insureds or co-insureds under the LEU Policies; (b) only PEC is named as an insured under

6. The three cases are *Adair State Bank v. American Cas. Co.*, 949 F.2d 1067 (10th Cir. 1991); *FDIC v. Aetna Casualty & Surety Co.*, 426 F.2d 729 (5th Cir. 1970); *Puget Sound Nat. Bank v. St. Paul Fire & Marine Ins. Co.*, 32 Wash. App. 32, 645 P.2d 1122 (1982).

the LEU Policies; (c) the creditors are not intended third-party beneficiaries of the LEU Policies under New Jersey law; (d) the creditors are subject to the same defenses which the LEU have against PEC; (e) the creditors are barred by PEC's breaches; (f) the creditors have no reasonable expectation of coverage; and (g) PEC's Trustee did not assert that he had standing to raise any claims on behalf of PEC's creditors in the District Court or Second Circuit.

A. Only PEC Has A Right To Claim Under The LEU Policies

PEC is the sole named insured under the LEU Policies (JA 1006, 1008, 1040, 1052, 1065, 1075). No protection is provided by the Policies to any other entity or person. Therefore, as "non-insureds" PEC's creditors are precluded by New Jersey law from recovering under the LEU Policies. *Dawson v. National Union Fire Ins. Co. of Pittsburgh PA.*, 285 N.J. Super. 137, 141-43, 666 A.2d 604, 606-07 (App. Div. 1995), *cert. denied*, 143 N.J. 517, 673 A.2d 276 (1996); *Liberty Mutual Fire Ins. Co. v. Kahlaid Inc.*, 199 N.J. Super. 494, 497-98, 489 A.2d 1231, 1232 (App. Div. 1985), *cert. denied*, 101 N.J. 300, 501 A.2d 958 (1986).

B. PEC's Creditors Are Not Beneficiaries Under The LEU Policies

Furthermore, PEC's creditors are not "intended" third-party beneficiaries under New Jersey law. New Jersey courts will not accord third-party beneficiary status unless the parties to the contract have explicitly stated: (1) that the third-party is an "intended beneficiary" of the proposed agreement; and (2) the third party has the right to make a direct claim under the contract. *Dravo Corp. v. Robt. B. Kerris Inc.*, 655

F.2d 503, 510-11 (3d Cir. 1991) (applying New Jersey law, court denied "intended third-party beneficiary" status to plaintiff under the aforementioned two-part test); *First Nat. State Bank of N.J. v. Commonwealth Federal Savings*, 610 F.2d 164, 170-71 (3d Cir. 1980) (same); *Air Master Sales Co. v. Northbridge Park Co-Op Inc.*, 748 F. Supp. 1110, 1117 (D.N.J. 1990) (same). New Jersey law further provides that a third party who merely stands to benefit from the contract is no more than an "incidental beneficiary" to the contract and possesses no contractual right to enforce the contract. *Grant v. Coca-Cola Bottling Co.*, 780 F. Supp. 246, 248-49 (D.N.J. 1991) (applying New Jersey law). The foreseeability of a prospective benefit to a third party from a contract is not enough to establish that party's right to enforce the contract. *Id.*

In New Jersey, as elsewhere, a person becomes an "intended beneficiary" to an insurance contract only if he or she is named as an "Insured" or "Co-Insured" under the contract. *See Liberty Mutual, supra* (a policy covering personal property of the insured which was also subject to a security interest did *not* protect the secured creditor against a loss caused by the insured's own wrongful act because the secured creditor was a mere "incidental beneficiary" under the policy; to be protected against such a loss, the secured creditor would have had to have been designated as a "Co-Insured" under the policy). *Accord Stainless, Inc. v. Employers' Fire Ins. Co.*, 69 A.D.2d 27, 34-35, 418 N.Y.S.2d 76, 80-81 (1st Dept. 1979), *aff'd*, 49 N.Y.2d 675, 428 N.Y.S.2d 675, 406 N.E.2d 490 (1980); 18 *Couch On Insurance 2d* § 74:330; Corbin, "Contracts For The Benefit Of A Third Person," 27 *Yale L.J.* 1008, 1017 (1918). Here, the LEU Policies do not name PEC's creditors as "Insureds" or "Co-Insureds." Moreover, the LEU Policies do not contain

express language stating that PEC's creditors have the right to make direct claim against the LEU under the Policies. PEC's creditors simply have no cognizable rights under the LEU Policies.

Because none of PEC's creditors entered into an independent contract with the LEU, PEC's creditors are subject to the same defenses which the LEU have against PEC and its Trustee. *Liberty Mutual*, 199 N.J. Super. at 497-98, 489 A.2d at 1232; *Wometco Home Theatre Inc. v. Lumberman's Mutual Casualty Co.*, 97 A.D.2d 715, 716, 468 N.Y.S.2d 625, 626 (1st Dept. 1983), *aff'd*, 62 N.Y.2d 614, 476 N.Y.S.2d 116, 464 N.E.2d 484 (1984). *See* Williston, "Contracts For The Benefit Of A Third Person," 15 *Harvard L. Rev.* 767, 797-98 (1902). As a result, if, as both the District Court and the Second Circuit held, the LEU possess valid defenses against PEC and its Trustee, then those same defenses are also valid against PEC's creditors.

C. *Tison Hog Market* Is Inapplicable

After the Second Circuit issued its opinion in this case, the Eleventh Circuit issued its opinion in *Tison Hog Market*, *supra*. The Trustee's heavy reliance on *Tison Hog Market* is misplaced, however, because that case involved a "surety bond," and not, as here, a "fidelity policy." A contract of suretyship such as the one at issue in *Tison Hog Market* is a contract whereby one party (the surety) engages to be answerable for the debt, default, or miscarriage of another. *Black's Law Dictionary* 751 (5th ed.). Surety bonds typically name the third-party obligee in the contract as a party to the contract who has an independent right to sue the surety and obtain payment.

"Fidelity policies" differ in that they only cover the insured company (here, PEC) against losses caused by the dishonest acts or thefts of its employees. *RTC v. Moskowitz*, 845 F. Supp. 247, 249-50 (D.N.J. 1994) (applying New Jersey law); *Oritani Savings & Loan v. Fidelity & Deposit Co.*, 821 F. Supp. 886, 290-91 (D.N.J. 1991) (applying New Jersey law); *North Jersey Savings v. Fidelity & Deposit Co.*, 283 N.J. Super. 56, 65, 660 A.2d 1287, 1291 (L. Div. 1993). *Accord*, *Glusband v. Fittin, Cunningham & Lauzon, Inc.*, 892 F.2d 208, 209-10, 212 (2d Cir. 1989) (applying New York law); *Leucadia, Inc. v. Reliance Ins. Co.*, 864 F.2d 964, 966 (2d Cir. 1988), *cert. denied*, 490 U.S. 1107 (1989) (applying New York law); *FDIC v. St. Paul Fire & Marine Ins. Co.*, 942 F.2d 1032, 1034-36 (6th Cir. 1991) (applying Tennessee law). Third-party non-insureds (such as defrauded customers or creditors of the insured company) have no rights to seek reimbursement from the insurer under a "fidelity policy." *Moskowitz*, 845 F. Supp. at 249-50 (applying New Jersey law). *Accord*, *People's Bank & Trust Co. v. Aetna Casualty & Surety Co.*, 113 F.3d 629, 634 (6th Cir. 1997) (applying Kentucky law); *First Nat. Bank of Louisville v. Lustig*, 975 F.2d 1165, 1167 (5th Cir. 1992) (applying Louisiana law); *Lynch Properties Inc. v. Potomac Ins. Co.*, 962 F. Supp. 956, 961-62 (N.D. Tex. 1996), *aff'd*, 140 F.3d 622 (5th Cir. 1998) (applying Texas law); *Gasselin v. National Union Fire Ins. Co. of Pittsburgh PA.*, 918 F. Supp. 373, 376-77 (M.D. Fla. 1995) (applying Florida law); *175 East 74th Corp. v. Hartford Acc. & Indem. Co.*, 51 N.Y.2d 585, 592, 435 N.Y.S.2d 584, 587, 416 N.E.2d 584, 587 (1980).

The distinctions between a "surety bond" and a "fidelity policy" are significant because under New Jersey law (as elsewhere), a "fidelity policy," unlike a "surety bond,"

will be subject to rescission if the insured company makes material misrepresentations in its insurance application to the fidelity insurer. *FDIC v. Moskowitz*, 946 F. Supp. 322, 329-32 (D.N.J. 1996) (applying New Jersey law). *See* J. Powers, "Pulling The Plug On Fidelity, Crime, and All-Risk Coverage: The Availability of Rescission As A Remedy Or Defense," 32 *Tort & Ins. L.J.* 905, 906 (1997) (cited with approval in *FDIC v. Underwriters of Lloyd's, London*, 3 F. Supp. 2d 120, 138 (D. Mass. 1998)).

D. PEC's Trustee Has No Standing

Finally, the Second Circuit correctly noted that since PEC's Trustee had not previously asserted that he had standing to raise any claims on behalf of PEC's creditors, it could not consider the argument made by PEC's Trustee as anything but derivative of the debtor PEC's rights. *Payroll Express*, 186 F.3d at 210 n.6. PEC's Trustee's petition does not challenge that holding. Even if PEC's Trustee had challenged it, however, the challenge would be untimely because PEC's Trustee cannot raise new issues for the first time on appeal. *Teague v. Lane*, 489 U.S. 288, 297 (1989).

CONCLUSION

The petition should be denied.

Both the District Court and the Second Circuit properly applied New Jersey law when they concluded that the LEU Policies should be rescinded based on PEC's response to Questions 10 and 36 on PEC's written application form.

Respectfully submitted,

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